WHAT IS WRONG WITH OUR BANKING AND CURRENCY SYSTEM?[1]

In simple terms commercial banking consists of accepting deposits, with an agreement to repay in money on demand, and at the same time lending the larger portion thereof repayable at future dates. The funds deposited are less than 10 per cent in money. Baldly set forth, such a procedure would seem a perilous undertaking with the hazard of failure ever imminent. If all banks were called upon at the same moment to make good their contracts to pay all their deposits in money, not only would they be utterly unable to do so, but there would not be money enough in the world to render such a thing a physical possibility. The safety of such a banking method rests upon the law of averages ascertained through experience which has demonstrated that the kaleidoscopic convenience of the multitudes using banks leads to such deposits and withdrawals as nearly offset one another.

If the absolute certainty of ability to pay all depositors in money on demand be taken as the *summum bonum* of banking, an idea which quite generally prevails among the unthinking, it is interesting to reckon the cost. A bank has no fairy wand with a wave of which it can transmute into gold the amounts due it, whether represented by borrowers' notes or balances due from other banks. Such repayments have an element of uncertainty which pervades all human affairs. All uncertainty could be eliminated only by having in money on hand an amount equal to the total of liabilities to depositors. A deposit with a bank would then be simply a warehousing transaction.

This would involve the withdrawal from use in the commerce of the country of more than eight billion dollars now loaned from funds deposited with banks, and a necessary contraction of our commerce within limits correspondingly narrowed.

If a readjustment to such a condition were accomplished, and if we consider only the ultimate result, and not the cataclysm of the process, it would clearly prove such an extinguishing restriction

[1] A paper read before the Western Economic Society, November 11, 1911.

of commerce as would cost fabulously more than the value of the advantage gained. It would be like preferring the constitution of a jelly-fish to that of a human being in order to avoid the hazard of fracturing a bone.

The incentive which leads to the creation of banks is profit, the chief source of which lies in lending a portion of funds deposited. The rates for loans and consequently the limitations of profit are fixed by the freest competition, as capital engages in banking more readily, and upon the assurance of a smaller return of earnings, than in almost any other field of enterprise. The proverbial animosities and jealousies of competing bankers evidence the genuineness of the competition.

Eliminate the opportunity for profit, and there would be no banks. Picturing a commercial situation under such conditions can lead only to the conviction of their incalculable value in the complex mechanism of our commerce. The extensions of credit, possible only through the medium of banks, are so essential to extensive commerce that without them its volume by comparison would be insignificant. If banks are vitally necessary to commerce, it follows that, whether used directly or not, they are vitally necessary to everyone engaged in any branch of production, transportation, or distribution, and most of all to wage-earners, who, as Mr. J. V. Farwell has pointed out, would be most benefited by a sound banking system. The continuity of their employment and the regularity of payment of their wages are largely due to bank loans to employers whose cash resources could not otherwise be constantly adequate.

The conclusion seems clear that only by having banks which employ in loans a part of depositors' capital lodged with them, can the best interests of the whole people be served, even if this entails something less than an absolute certainty of power to liquidate deposits on demand. That banking system must then be best which combines equally the largest measure of each of two elements: the use in commerce of funds deposited, and the certainty of paying depositors in money on demand.

Our banking system is one in which the banks thus lend a portion of funds received on deposit, which is indeed true of those of every

civilized country. But while they have this essential characteristic in common, it must be admitted that the commerce of this country is not served with an efficiency and dependability equal to that shown by the banks of some other countries. We have, as some other countries do not, financial panics and currency famines which disorganize our commerce disastrously at the very times when it seems most active and most prosperous.

What then is wrong with our banking system?

Our national banking law requires that a bank must constantly have reserve money on hand equal to a specified percentage of its deposit liabilities. If it were required that this should be apportioned pro rata for each depositor, and that the money set apart as reserve against one deposit balance should not be used to pay another, the bank could not be sure of meeting the demand of a single depositor for the amount due him, unless it carried 100 per cent reserve against all deposits. But if these separate reserves were gathered into one mass, available for any demands, the bank could operate with a high degree of safety by having on hand in money only a small percentage of the aggregate amount owing depositors, and would consequently be able to lend for use in the commerce of its vicinity the greater part of such funds. Under normal conditions deposits and withdrawals would nearly offset one another, so that the bank would actually use very little of its reserve money. Efficiency in serving the commerce of its community, which is the source of its own profit, and at the same time strength to meet depositors' demands can be attained only through thus gathering into one mass the reserves held against each separate deposit balance.

Turning now to the vast system of banks throughout the country, if all the depositors of each bank be regarded as merged into a single individual, all banks taken together would then be in a situation similar to that of the single bank just mentioned, each bank holding its separate reserve against its one deposit, the reserve of one bank not available to pay the deposit of another. No one of them would surely be able to meet the demand of its one depositor for the amount due him unless all carried 100 per cent money reserve. But if the separate reserves of all the banks

were gathered into one mass, available to meet the demands of depositors for payment in money, whether made in Maine or Texas, New York or California, the banks of the whole system, as in the case of the single bank cited, would be able to operate with the highest degree of safety by having a total sum of money equal to only a small percentage of the aggregate amount owing to depositors, and consequently would be able to lend for use in the commerce of the country the greater proportion of the funds deposited. The total of deposits and withdrawals made throughout the country would very nearly offset one another. Very little of the reserve money would actually be used. A special requirement of one section would represent only a small percentage of the total massed reserves. The country has such vast area, and the requirements in different parts so vary in season that a deficiency of money in some sections would find a measurably offsetting surplus in others.

Applied to a system of banks, this principle would be that of a single institution with local offices throughout the country. Theoretically the maximum ability to serve and maximum strength to withstand would exist in such an institution of one ownership, controlling under one management the entire reserves, each deposit with a local office a liability and each loan an asset of the one institution. Its vast loanable funds would be equally available for every section, and its mass of reserve money would be so great that a special demand from any section for payment of deposits in money would make only an imperceptible drain.

While theoretically an institution so constituted would be strongest and most efficient, none such exists, and no one would advocate such a system. Omniscience and omnipotence would be required for its wise administration.

But the conclusion seems clear that only in proportion to the massing of reserves can efficiency in lending for commerce be combined with strength to pay depositors. The greater the proportion of the entire reserves gathered into one mass, the greater the efficiency and strength rendered possible. This principle is fundamental.

To maintain the individual identity, separate ownership, and absolute independence of our twenty thousand banks and at the same time to endow them with both the ability to serve efficiently the

commerce of their respective localities and also the strength to meet special strains, whether local or general, it would seem that the only way would be to follow a middle course. This would be so to co-ordinate the banks of the system that it would be possible to mass part of the reserves, thereby securing a measure of efficiency and strength which, if not the theoretical maximum, would practically, at least, be adequate.

With banks self-dependent as now, each must carry constantly a reserve which it regards as sufficient not only for normal conditions but for fortification against special demands. If this surplus of reserve beyond that for normal conditions were lodged with a co-operative agency, it would gather into one mass that portion of the reserves now held for possible requirements beyond the ordinary. This would constitute a vast consolidated reserve fund available as a basis for extending credit, or furnishing reserve money in exchange for acceptable loan assets, to those banks in any section of the country upon whom special demands might be made at any time by their depositors.

Summing up, the fundamental defect of our banking system is the parcellation of the entire reserves among the separate self-dependent banks, necessitating either a wastefully large proportion of reserve for assured ability to pay, with correspondingly inefficient service to commerce, or efficient service with the hazard of unexpected exhaustion of reserves and consequent inability to make good the contracts to pay depositors in money on demand.

The remedy would be the massing of a portion of the reserve money in a co-operative agency available to render assistance when required by the banks of any section.

THE CURRENCY

Nearly a billion dollars of the gold in the Treasury is not owned by the government, but is held in trust to redeem an equal amount of gold certificates outstanding. The other forms of money, aggregating approximately two billion dollars, are, in last analysis, the government's promises to pay gold on demand. A specific gold reserve of 150 millions is set apart against the greenbacks and Treasury notes. Silver must be maintained at a parity with gold,

which can mean only its redemption in gold if necessary to that end. The government must redeem national bank notes on demand, if the issuing banks fail to do so, and recoup itself from the sale of government bonds held as collateral and from the prior lien on assets. Redemption of national bank notes, authorized by law, in other forms of lawful money, greenbacks and silver, would be no escape from redemption in gold, since these forms must be exchangeable for gold. In addition to the special gold reserve of 150 millions held against the greenbacks, the Treasury now has approximately 130 millions of gold in its general fund.

If a criticism be made that 280 million dollars is an insufficient reserve against direct and contingent demand liabilities of two billion dollars, this could be met by increasing the reserve to the point that its financial soundness would be beyond question. But this would not give our present currency economic efficiency.

What then is wrong with our currency system?

Aside from trust funds not owned by the government only about one-tenth of our money is in the Treasury. The vast bulk of our money of all forms, aggregating approximately three billion dollars, is divided into two not very unequal parts, one of which is that in bank reserves.

When a bank's reserve exceeds the percentage which it deems adequate to enable it to pay depositors in money on demand, according to its contracts, it makes additional loans until its reserve represents the desired percentage of its deposit liabilities; and if its reserve falls below the desired percentage, it requires payment of maturing loans until its money reserve again represents the desired percentage. The continuous deposits and withdrawals of depositors, according to their convenience and needs, cause a constant fluctuation in the aggregate of a bank's deposits. As the total of its deposits expands or contracts, the only means of adjusting its money reserve to the desired percentage lies in increasing or diminishing the amount of its investments. Bank loans are most intimately related to reserves. Aside from loans of capital, they owe their existence entirely to reserves. Expansion of bank reserves involves expansion of loans, and contraction of reserves, contraction of loans.

The other part of our money which is not in bank reserves is in circulation, that is, in the tills of merchants, in the pockets of the people. Banks are constantly paying out money, withdrawn by depositors, which goes into circulation. This is not at the volition of the banks but because those owning the right to it exercise their preference to have money instead of deposits subject to check. As such money is spent, merchants and others who receive it redeposit it in banks, again not because banks desire this, though to be sure they are willing, but because merchants prefer to exchange money for rights to check, their payments being more conveniently made by check. The resultant of the preferences of those owning rights to money determines the volume of money in circulation. It is beyond the power of banks to control this. Bank reserves viewed as a whole are not the amount which banks desire for that use but the amount remaining after the demands are satisfied for money to circulate. To illustrate: A manufacturer draws for his pay-roll the requisite money which thus goes out of bank reserves into circulation. The individual replenishes his pocket money according to his convenience and habit, reducing bank reserves and adding to the money in circulation. The merchant deposits the amount received from cash sales, increasing bank reserves and reducing the amount of money in circulation.

No tax paid by banks upon money which they disburse would drive it out of circulation into bank reserves. If needed or desired, it would remain in circulation. It would go out of circulation and into bank reserves only when those having the money preferred to exchange it for rights to check.

Under our present system the volume of money in circulation is perfectly flexible. It constantly expands and contracts in automatic adjustment to the requirements of trade and the convenience of the people. An increase in the volume of cash transactions brings promptly an increase in the volume of currency in circulation through the current withdrawals of money exceeding the current deposits of money. A lessening in the volume of cash transactions promptly drives unneeded currency out of circulation through the deposits of money exceeding the withdrawals. No other system could provide a currency which would adjust its

volume in circulation more exactly to the needs of trade and the preferences of the people. There is a ceaseless flow of the money in circulation into bank reserves, and of money in bank reserves into circulation—ceaseless except in an occasional crisis when the natural flow of money from bank reserves into circulation is arbitrarily stopped by banks refusing, for self-protection, to continue paying out to the point of exhausting reserves.

While the volume of money in circulation is thus perfectly and automatically adjusted to trade requirements, it is to be noted that this flexibility arises from the flow back and forth, between the mass of money in circulation and the mass in bank reserves. In this lies the main economic defect of our present currency system. An expansion in the volume of money in circulation entails a corresponding contraction in the volume of bank reserves, and necessarily, as previously pointed out, a corresponding contraction in loans. A period of expanding business would naturally be attended by both an increased volume of loans and an increased volume of cash transactions, such as increased pay-rolls, increased retail sales. Increased cash transactions cause a larger volume of money to flow into circulation. But this flow is out of bank reserves, thus contracting them and necessitating a contraction of loans depending upon them, at the very time when loans would naturally expand. Obviously, if business becomes very active, the effect upon bank reserves is so adverse, and the contraction of loans depending upon reserves so important, that embarrassment is widespread and panic ensues.

It would be a remedy to have the volume of money in circulation find its adjustment in a flow from bank deposits into money in circulation, and from money in circulation into bank deposits, instead of through a flow between bank reserves and money in circulation. Such a result would be attained by the use of bank notes as our ordinary currency.

True, bank notes are simply a bank's promises to pay money, the same as are bank deposits, each backed equally by the bank's assets including the same proportion of money reserves. A conversion of its deposit promises into bank-note promises, as Mr. F. A. Vanderlip has aptly expressed it, or bank-note promises into

deposit promises, would in no wise change the total of its liabilities. The two kinds of promises, interchangeable at the will of the depositor, are identical in substance, differing only in form, each being simply promises to pay money.

A manufacturer drawing upon the bank for currency for a pay-roll and receiving bank notes thereby causes a reduction in the bank's deposit liabilities and a like increase in its bank notes in circulation. A merchant depositing bank notes thereby increases the bank's deposits, and contracts to the same extent the volume of its bank notes in circulation. To place its own bank note in the issuing bank's possession would in effect cancel it the same as if it were destroyed. It would be similar to the promissory note of an individual coming into the maker's possession. If a bank note were reissued, it would be in exchange for a new asset and would be a new promise to pay money as much as if the old bank note were destroyed and an entirely new note issued in the new transaction. Those owning rights to draw, as Professor Irving Fisher states it, would determine according to their convenience whether they preferred deposits subject to check or bank notes. The requirements of trade and the preference of the people would thus determine what portion of the bank's obligations would be expressed by deposit promises and what portion by bank-note promises. There would be a constant flow from bank deposits into bank notes in circulation, and from bank notes in circulation into bank deposits. Such an interchange would in no wise disturb the bank's reserve money and consequently would in no wise affect the loans depending upon the reserves. This would be true even if everyone owning a right to draw should prefer bank notes for the entire amount due him, thus converting the entire bank deposits into bank notes in circulation. It would be all one to the bank, no advantage and no disadvantage. Its total liabilities would be unchanged and its money reserves unchanged. None of the capital lodged with it by depositors would be withdrawn in such an exchange. A situation approaching this does now exist with some of the great European banks in countries where the deposit and check system is little developed, the principal part of the liabilities being bank notes in circulation.

To simplify the illustration of the principle, I have spoken of the bank as a single institution. But whether one great institution or twenty thousand individual banks issued such bank notes, they would effect the same result of protecting from disturbances both the reserves and the loans depending upon those reserves.

If the co-operative reserve-holding agency, previously mentioned, were given sole authority to issue such bank notes, it would naturally use them in current payments of depositors' checks, thus leaving undisturbed the reserve money with which such deposits had been created. Current deposits with such an agency would consist to some extent of gold and other forms of lawful money as well as of its own bank notes. The continuous process of receiving such deposits and paying checks with bank notes would gradually exchange bank notes for the gold, silver, and greenbacks in circulation, thus concentrating the lawful money with the agency and rendering its bank notes our ordinary currency. With the principal part of the lawful money of the country massed in such a co-operative agency, its money reserve would be so vast that it would have strength, abundant beyond question, to serve efficiently the banks and through them the commerce of the country with the needed extension of credit even in severest stress, thus providing protection against financial panics. Deposit credits, including those created by loans, would be exchangeable at the will of the depositing bank for bank notes, so that the hazard of currency famines would be eliminated.

Summing up, the main defect of our present currency system is that the volume of currency in circulation has its adjustment in the flow from bank reserves into money in circulation and from money in circulation into bank reserves, causing a contraction of bank reserves and the loans depending on them as business expands, and an expansion of reserves and of loans as business contracts.

A remedy would be the use of bank notes through which the volume of currency in circulation would have its adjustment in the flow from bank deposits into bank notes in circulation, and from bank notes in circulation into bank deposits, thus protecting from disturbance both bank reserves and the loans based on them.

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